Materiality matters: Targeting the ESG issues that impact performance

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Russell Investments has developed a new way to measure a company's ESG (environmental, social and governance) score. Our evidence suggests that the Russell Investments material ESG scores can potentially provide more insight than broader ESG scores. Request our Materiality Matters research

At Russell Investments, we believe that a sound awareness of ESG factors and a robust process can help to deliver strong investment returns and meet objectives over the long-term. So, we asked ourselves: Can materiality help to deliver strong performance?

Materiality and the Task Force on Climate-related Financial Disclosures (TCFD)

Formed in December 2015, in response to a call from the G20, the Financial Stability Board have developed some clear recommendations for voluntary climate-related Financial disclosures. One of those recommendations is for companies to look at materiality. Philippe Désfosses, CEO of French pension scheme ERAFP and vice chair of IIGCC, said:

The more companies report effectively on climate related risks and opportunities, the easier it becomes for investors to allocate the substantial amounts of capital required to implement the Paris Agreement and to work on their own climate risk disclosure. There should be no resistance to the widespread adoption of the TCFD's recommendations given how - in most G20 countries - companies already have legal obligations to disclose material risks in their routine financial filings, including those that related to climate change.

Not all ESG issues matter equally

The relevance of ESG issues varies industry to industry, company by company. For example, fuel efficiency has a bigger impact on the bottom line of an airline than it does for an investment bank. So, rather than adopt a one-size-fits-all approach, we have worked to develop a new ESG scoring framework that is specific or truly material to a company and their profitability.

Why? We have found that traditional ESG scores are composed of a large number of issues that are not material for every industry or company. Specifically, for two-thirds of all securities in the Russell Global Large Cap Index universe, less than 25% of the data items in the traditional score are considered material.

So, to generate our new score, we have leveraged the traditional ESG scores provided by the data provider Sustainalytics alongside the industry-level materiality map developed by the Sustainability Accounting Standards Board (SASB). Then we asked ourselves, can this new score be used as an ESG signal for investment decision making?

SASB and Sustainalytics - who are they and what do they do?

Sustainalytics

Sustainalytics provide data for 145 sustainability categories divided into environmental (E), social (S) and governance (G) issues. Scores for these subcategories are then rolled up into aggregated E, S and G scores which are further rolled up into an aggregated ESG score for each company. Sustainalytics acknowledges that not every subcategory is relevant to every industry. To reflect this, data is not provided for each industry in each category.

SASB

The mission of the SASB is to develop sustainability accounting standards that help companies disclose value-relevant information to investors via standardised filings. SASB use a six-step process before making a final determination that a sustainability issue is material.[1] The SASB materiality map is the product of this, and explicitly identifies the material ESG issues to industry groups.

New material score methodology and findings

We used the materiality map released by the SASB to help us determine which of the 145 ESG issues from Sustainalytics data set could be deemed as material to companies' bottom lines. Following this, we used a number of statistical techniques to help formulate and standardise what we have coined ‘the new material ESG score'.

By looking at the correlation between traditional ESG scores and the new material score, our research has indicated that there is indeed a meaningful difference between the two scores. We have found that there is a benefit to investors who differentiate between a company's financially material ESG issues and non-financially material issues.

So, does materiality matter? Yes.

Industry bodies actively promote and recommend that companies need to focus more on the material ESG issues that directly affect their bottom line. We have been able to do just that, and construct a new ESG score that focuses solely on material issues.

Ultimately, our new score allows us to differentiate between companies in a way that the traditional score does not facilitate. We can now distinguish between companies who score highly on ESG issues that are financially material to their business, from those who score highly on issues that are not financial material to their business. Our research suggests that the Russell Investments material ESG scores can provide insights beyond traditional ESG scores.

Interested to learn more? **Request our Materiality Matters research**

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[1] Source: 'SASB's Approach to Materiality for the Purpose of Standards Development' Staff Bulletin No. SB002-07062017. July 2017.

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